Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products - Recourse by the United States to Article 21.5 of the DSU

EXECUTIVE SUMMARY OF THE UNITED STATES

I. FIRST WRITTEN SUBMISSION

A. Introduction and Procedural History

1. On 27 October 1999, the Dispute Settlement Body ("DSB") found in *Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products* that Canada's Special Milk Class ("SMC") system, which provides milk at reduced prices to processors for the manufacture of dairy products for export, constitutes an export subsidy for purposes of the *Agreement on Agriculture*. The DSB also concluded that Canada exported a greater quantity of subsidized dairy products than is permitted by its reduction commitments on export subsidies and, therefore, breached its obligations under the *Agreement*. Accordingly, the DSB recommended that Canada bring its export subsidy regime into compliance with its export subsidy reduction commitments under Articles 3.3 and 8 of the *Agreement on Agriculture*.

2. Although the reasonable period of time for Canada to comply with its export subsidy obligations expired on 31 January 2001, Canada's export subsidies have not been brought into conformity with the DSB's rulings and recommendations as Canada persists in subsidizing dairy exports at a level that is inconsistent with its reduction commitments. To address Canada's continuing breach of its export subsidy obligations, the United States requested that this Panel be convened pursuant to Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU").

B. Canada Continues to Provide a Subsidy in the Form of Discounted Milk Only to Exporters

3. While the programs introduced in August 2000 are in some regards different from the Special Milk Class 5(e) which they replace, their objective, the provision of low priced milk to exporters to make dairy exports commercially viable, is precisely the same. The new programs vary somewhat from province to province, but possess several common elements. Specifically, the provincial programs allow exporters to purchase milk at prices that are below prevailing market levels for milk used in dairy products sold into Canada's domestic market. The low-priced milk made available to dairy processors and exporters can only be used to manufacture dairy products for export. Thus, the availability of such discounted milk is contingent on export. Furthermore, any person that diverts the low-priced milk, products made from it, or components of the milk, into Canada's domestic market faces severe sanctions.

4. Because Ontario and Quebec account for the vast majority (approximately 80 percent) of dairy product exports from Canada, the United States focused on the fundamental aspects of the provincial regimes that have been established there. There are four core elements to those provincial regimes. First, any milk produced above the level of the domestic quota must be sold

for export-only processing (or relegated to use in the production of animal feed). The milk that is committed to export may not be introduced into the domestic market; such milk (or the resulting dairy products) must be exported. Second, the price paid by exporters for milk produced outside of the domestic quota is not regulated; this is in contrast to milk produced within the domestic quota, for which prices are specifically established by the provincial authorities. Third, any milk producer desiring to contract to provide milk for export must do so through a single, mandatory offer-and- acceptance process established by the provincial milk marketing board in conjunction with dairy processors in each province. Fourth, the export contracts are policed and enforced by the federal and provincial governments through a comprehensive array of mechanisms. While the contracts can be enforced by the private parties themselves, they are also subject to audit and enforcement by both provincial and federal authorities. For example, in Quebec a substantial monetary penalty is imposed on any entity diverting into Canada's domestic market any milk or milk products committed to an export contract.

5. The Canadian Dairy Commission (CDC) also continues to play a central role in the export of dairy products. Although Canada has eliminated Special Milk Class 5(e), the CDC is still involved in the issuance of permits and the negotiation of milk prices for Class 5 (d) and 5(a), 5(b) and 5(c). Also, the CDC remains heavily engaged both in the operation of Canada's supply management system, as well as in the enforcement of the export mechanisms recently created by the provinces. For example, pursuant to section 10 of the federal regulations, the CDC possesses the authority to audit the books and records of both producers and processors to determine whether milk committed for export has in fact been exported. In addition, under new section 11(1), the CDC's inspectors have the authority to seize any dairy product that the inspector believes on reasonable grounds was marketed in interprovincial or export trade in contravention of the federal regulations.

C. Legal Argument

6. The fundamental obligation of the *Agreement on Agriculture* concerning export subsidies is contained in Article 8, which provides that: "Each Member undertakes not to provide export subsidies other than in conformity with this *Agreement* and with the commitments as specified in that Member's Schedule." Article 3.3 of the *Agreement*, in turn, provides that a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in excess of the budgetary outlay and quantity commitment levels specified in Section II of Part IV of that Member's Schedule. To ensure, moreover, that the disciplines on export subsidies contained in Article 3.3 are not circumvented, Article 10.1 of the *Agreement* directs that any export subsidy not identified in Article 9.1 may "not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments . . ." Thus, a Member may use export subsidies not listed in Article 9.1 only within the limits of its scheduled reduction commitments.

7. Given this framework, any export subsidy that falls either within the scope of the export subsidy descriptions contained in Article 9.1 or within the broader reach of Article 10.1 of the

Agreement is subject to the limitations, both budgetary and quantitative, included in each Member's Schedule. The United States considers that Canada's provincial export measures are export subsidies within the meaning of Article 1(e) of the *Agreement* and, therefore, must be confined within the quantitative limits prescribed in Canada's Schedule. Canada's failure to respect its Schedule limitations on export subsidies is, in turn, a failure to comply with the DSB's recommendations to bring its milk export subsidies into conformity with the *Agreement*.

1. Article 9.1(c) of the Agreement on Agriculture

8. The text of Article 9.1(c) establishes two conditions for finding an export subsidy. There must be: (1) payments on the export of an agricultural product and (2) those "payments" must be "financed by virtue of governmental action." The new provincial export schemes fulfill both of these conditions and, thus, constitute Article 9.1(c) export subsidies.

9. The Appellate Body articulated the standard for determining whether a "payment" exists as follows:

> If goods or services are supplied to an enterprise, or a group of enterprises, at reduced rates (that is, at below market-rates), "payments" are, in effect, made to the recipient of the portion of the price that is not charged. Instead of receiving a monetary payment equal to the revenue foregone, the recipient is paid in the form of goods or services. But as far as the recipient is concerned, the economic value of the transfer is precisely the same.

10. Under the new provincial programs, the export contract prices offered are significantly below the market prices paid for milk entering Canada's domestic market for final consumption. For example, the average price for Class 3 milk sold into the Canadian market for ultimate consumption within Canada was about C$56 per hectoliter for the period August to December 2000, about 85 percent above the much lower price offered in export contracts reported for the same month. Thus, just as in the case of the earlier Special Milk Class system, the new provincial export measures result in milk producers providing milk for export at a substantial discount to the prevailing market price for milk delivered for ultimate consumption in Canada. Milk producers are now foregoing revenue in the same manner that the Panel and Appellate Body found to constitute a "payment" for purposes of Article 9.1(c) under the Special Milk Class system.

11. With regard to the second prong of the Article 9.1(c) analysis, because the CDC, Canada Milk Supply Management Committee, the provincial governments and the milk marketing boards are all governmental, a presumption should exist, consistent with the Appellate Body findings relating to the Special Milk Class system, that the provision of discounted milk for export through the new export schemes is "financed by virtue of governmental action" for purposes of Article 9.1(c) of the *Agreement on Agriculture*.

12. Additionally, the Appellate Body declared that in determining whether a payment is "financed by virtue of governmental action," government's involvement as a whole must be considered. The Panel's assessment in this regard should give consideration to three related elements of Canada's government-mandated dairy regime. First, Canada distinguishes between milk destined for consumption in its domestic market and that which is exported. Whereas milk sold into the domestic market is regulated with respect to both quantity ceilings and price floors, milk that is designated for export markets is entirely exempt from such regulation (and hence is supplied at a discount). To enforce this distinction in treatment, government regulations prohibit milk produced outside of milk producers' domestic quotas from being sold into the Canadian market for final consumption there. Second, in Ontario and Quebec which account for approximately 80 percent of production, all milk destined for export must be sold through an exclusive, mandatory bulletin board system where processors invite offers of milk for specific export contracts at prices established by the processors. And, third, the governing provincial regulations require that any milk committed to export contracts through the new export schemes must be exported

13. A review of the government regulatory context in which the export programs operate demonstrates that, not only is government action involved, but that it is indispensable. Canada's milk regime does not afford milk producers the liberty to choose where to sell the milk that they produce. By excluding over-quota and non-quota milk from the domestic market, Canada's governments make a separate pool of milk, that would not otherwise exist, exclusively available (for all practical purposes) for dairy processors for export. The exemption of "export contract milk" from domestic pricing regulation means that processors that export dairy products are not required to pay the higher domestic market prices for milk. The exemption from this additional expense results exclusively from the *government* action excluding export milk from the scope of the provincial boards' pricing authority over milk. The essential fact is that only through the exercise of government powers are exporters provided milk at discounted prices.

2. Article 10.1 of the Agreement on Agriculture

14. If the new Canadian export schemes are not considered to be export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, those schemes should then be found to be export subsidies for purposes of Article 10.1 of the *Agreement.*

15. The Appellate Body has stated that the obligations under Article 10.1 come into play when three factors are present: (1) there is a subsidy not identified in Article 9.1 of the *Agreement*, (2) that subsidy is contingent on export, and (3) the subsidy results in, or threatens to lead to, circumvention of a Member's export subsidy commitments.

16. The Appellate Body has drawn upon the definition of a "subsidy" in the *Subsidies and Countervailing Measures Agreement* (*SCM Agreement*) as context for construing that same term for purposes of the *Agreement on Agriculture.* A subsidy arises where the grantor makes a

"financial contribution" which confers a "benefit" on the recipient as compared with what would have been otherwise available to the recipient in the marketplace.

17. Here, exporters obtain milk on a discounted basis, at a lower price than would otherwise be available to them in their domestic market, which is practically speaking, the only market for milk in Canada. The exporters thus receive a benefit comprised of the cost savings resulting from the availability of lower priced milk.

18. Second, it is undisputed that the availability of discounted milk is dependent on use of the milk in the manufacture of dairy exports. Thus, it is a subsidy contingent on export.

19. Third, the subsidy results in or threatens to lead to the circumvention of Canada's reduction commitments. Because there is no constraint on the availability of the export subsidy created by the new export schemes, those export subsidies are unlimited in scope as are the exports they foster.

20. A finding that the new provincial export schemes are export subsidies within Article 10.1 is also supported by consideration of the schemes under Paragraph (d) of Annex 1 of the *SCM Agreement* - the Illustrative List of Export Subsidies. Like the Special Milk Classes, Canada's new provincial export schemes satisfy each of the elements under paragraph (d). First, as explained above, dairy processors continue to have access to milk through the electronic export contract bulletin boards that is priced on more favorable terms than would otherwise be available to such processors for milk in the domestic market. Second, the lower prices are only available for milk used in the production of export products. And, third, the lower-priced milk is provided by Canada's "governments or agencies directly or indirectly through government-mandated schemes.

3. Canada Is Exceeding Its Reduction Commitments

21. A review of available export data shows that, when the volume of exports made pursuant to Special Milk Class 5(d) is combined with exports made under the provincial marketing schemes, the total aggregate volume of exports of cheese already exceed Canada's reduction commitments and exports of other milk products is barely below the quantity of subsidized exports that may be permitted consistent with Canada's reduction commitments. Consequently, because the new provincial export schemes constitute export subsidies, Canada's exports of cheese and other dairy products breach its obligations under Articles 3.3, 8 and 9 of the *Agreement on Agriculture*

4. Article 3 of the SCM Agreement

22. In addition to constituting violations of Articles 9.1(c), or in the alternative, Article 10 of the *Agreement on Agriculture*, Canada's measures affecting the exportation of dairy products constitute prohibited export subsidies pursuant to Articles 1.1 and 3.1 of the *SCM Agreement*.

These measures -- Canada's new provincial export subsidy programs as well as the maintenance of Special Class 5(d) -- provide discounted milk to milk dealers on the condition that the milk is exported to foreign markets. They do so by allowing exporters to purchase milk at prices that are below prevailing market-levels as compared to milk used in dairy products sold in Canada's domestic market. Access to this low-priced product is contingent on the product being exported, because should a milk dealer divert the low-priced milk or products made from it to the domestic market, the milk dealer must pay a severe penalty. The result is that milk sold for export is often half the price of milk sold on the domestic market. Therefore, Canada's measures constitute subsidies contingent upon export performance in violation of Article 3.1(a) of the *SCM Agreement*.

II. REBUTTAL SUBMISSION

A. The Market For Export Milk Is Created And Controlled by the Canadian Government

23. The separate market for discounted export milk exists in all provinces solely by virtue of the government requirement that milk produced above or outside of domestic quota must be sold for export. By mandating the separation of the two markets, the Canadian government ensures that reduced price milk will be offered to processors for export. The producers have no real choice if they produce over-quota or without quota. They can either: 1) sell their milk into the export market for a lower price; 2) sell their milk into the animal feed market under Class 4(m) for an even lower price; or 3) destroy the extra milk which would have obvious political ramifications. The only real commercial option is to sell any over-quota or non-quota milk into the export market. By restricting the choice of the producer, the government enables the transfer of lower-priced milk to the processor. Absent these restrictions, the processor would have to pay the higher price applicable to milk for dairy products sold into the domestic market.

24. The government further secures the supply of discounted milk for the export market by requiring that producers "pre-commit" their milk destined for the export market and that export milk must be delivered "first out of the tank." This ensures that, by law, producers cannot abandon their obligations to supply milk for export at a discount from the domestic price. These requirements further demonstrate that the export market is not a true commercial market but rather a contrived market created and controlled by the Canadian government. While creating the impression that producers are making a commercial decision to produce for the export market, these two requirements help ensure that export milk is not redirected into the domestic market. In reality, producers are doing exactly what they did under the Special Milk Class program - arranging for the disposition of any milk not permitted to be sold in the domestic market

B. Legal Analysis

1. Burden of Proof

25. As specified by Article 10.3 of the *Agreement on Agriculture*, Canada bears the burden of establishing that its dairy management measures, including those putatively taken to comply with the DSB's recommendations, have not subsidized dairy exports in excess of its commitment levels under that *Agreement*. Canada has demonstrably failed to meet this burden.

2. Article 9.1(c) of the Agreement on Agriculture

26. Canada contends that there is no "payment" to processors because the processors are purchasing export milk at "market" rates, and not at reduced rates. The flaw in Canada's reasoning is that it has confused the appropriate benchmark for assessing whether export milk is made available to processors at below market rates. Canada's approach to analyzing whether a "payment" is conferred assumes that the appropriate benchmark is the export market price. However, this approach is inconsistent with the legal standard that the Appellate Body and the Panel in this case applied in determining the existence of a subsidy under Article 9.

27. In determining whether a "payment" is made within Article 9.1(c), this Panel must assess what would have been *otherwise available* to processors/exporters in the marketplace. For all practical purposes, the only source of milk otherwise available to Canadian processors/exporters is milk produced in Canada. And that milk is sold at a high price pursuant to regulation (unless, of course, the milk is destined for export). Just as in the case of the Special Milk Class 5(e) scheme, the processor is accessing milk for export at a price that is lower than would be paid by the same processor purchasing the same milk for use in manufacturing dairy products destined for the domestic market. Likewise, producers are providing milk for export at a substantial discount to the market price for milk delivered for domestic consumption.

28. With regard to the second prong of Article 9.1(c), it is clear from a review of the government's involvement that the payments to the processors under the provincial export programs are made by "virtue of government action." As previously explained, there are three primary indicia of the government's involvement in the new provincial export programs. These include: 1) the fact that Canada artificially segregates the market for milk that is exported and milk that is consumed domestically; 2) that provincial regulations require that any milk committed for export contracts through the new export schemes be exported, and that the provincial governments have sanction authority to enforce this requirement; and 3) that in Ontario and Quebec all milk destined for export must be sold through an exclusive mandatory bulletin board system.

29. Furthermore, the Panel in the original proceeding recognized the role of the domestic quota system in the transfer of resources from the producer to the processor under the Special Milk

Class system as "government action" within Article 9.1(c). Its analysis of this issue is directly applicable to the role of the domestic quota system and hence the government under the new provincial export programs.

30. In sum, Canada failed to refute that the overall action of Canadian governments in establishing domestic production quotas, in excluding over-quota and non-quota milk from the domestic market, in exempting export contract milk from domestic pricing requirements, in instituting mandatory and exclusive export contracting mechanisms, and in enforcing the various obligations arising from these regulatory requirements, and in enforcing the various obligations arising from these regulatory requirements, constitutes pervasive government intervention. It is only through the exercise of these government powers that exporters are provided milk at discounted prices. Accordingly, the requirement under Article 9.1(c) that payments are financed "by virtue of government action" is satisfied in this case.

3. Article 10.1 of the Agreement on Agriculture

31. Canada's argument in response to the United States' alternative argument under Article 10.1 of the Agriculture Agreement is without legal support and should be rejected by the Panel. Canada's argument that there must be a "direct connection" is not supported by the language of Article 10.1 of the Agriculture Agreement or paragraph (d) of the Illustrative List of Export Subsidies contained in Annex 1 to the SCM Agreement.

32. The United States pointed out that the original Panel concluded it was more appropriate to consider paragraph (d) of the Illustrative List than the general concepts of Article 1 of the SCM Agreement when analyzing the context of Article 10.1 of the Agriculture Agreement. As explained in the first written submission, the new provincial export programs satisfy each of the elements of paragraph (d). Accordingly, the new export programs constitute export subsidies for purposes of the SCM Agreement. Because the SCM Agreement is part of the context of the Agreement on Agriculture, the fact that the provincial programs constitute a subsidy under the Illustrative List supports a finding that the programs are export subsidies under Article 10.1 of the Agreement on Agriculture. Additionally, Canada did not dispute that there are no restraints on the availability of the export subsidies by the new export programs. Consequently, the export programs have already resulted in or threaten to lead to the circumvention of Canada's reduction commitment within the meaning of Article 10.1.

4. Article 3 of the SCM Agreement

33. In demonstrating a violation of Article 3 of the SCM Agreement, the United States relied upon paragraph (d) of the Illustrative List of Export Subsidies in Annex 1 to the SCM Agreement. Canada criticized this approach as inappropriately abbreviated. However, Canada adopted and indeed championed the same approach in another subsidies case. In *Brazil-Aircraft*,

Canada argued that a measure that satisfies the requirements of the Illustrative List is *ispo facto* an export subsidy and therefore prohibited. Just as in *Brazil-Aircraft*, the Panel in this dispute is confronted with a *per se* violation of Article 3 of the SCM Agreement.

III. ORAL PRESENTATIONS

A. Opening Statement

34. In the opening statement, the United States focused on the relevant facts that are not in dispute and the legal implications of those facts. Specifically, the United States pointed out that Canada does not dispute the following facts. First, Canada does not dispute that milk meeting the definition of "commercial export milk" in the federal and provincial regulations is excluded from the domestic regulations which set the domestic price under the domestic quota system. Second, Canada does not dispute that any milk committed for export, by law, must be exported. Third, Canada does not dispute that milk sold as an input for export dairy products is purchased at a lower-price than milk sold as an input for the same dairy products to be sold domestically. Fourth, Canada does not dispute that, by provincial regulation, producers must "pre-commit" to export contracts. Fifth, Canada does not dispute that, by provincial regulation, producers must deliver milk contracted for export "first out of the tank." Sixth, Canada does not dispute that both the federal and provincial governments play a role in monitoring and enforcing the requirement that milk contracted for export is not sold into the domestic market. And, finally, Canada does not dispute that, in Ontario and Quebec, all export contracts must be made through a single mandatory bulletin board mechanism.

35. The United States explained the legal implications of these facts under the Agreement on Agriculture and the SCM Agreement, emphasizing paragraph 7.100 of the original panel report in which the Panel concludes that the domestic quota system is "government action" that transfers resources from the producers to the processors. The United States pointed out that this paragraph of the panel report completely refutes the entire premise of Canada's case - which is that the export market and the decisions made by the producers participating in that market are wholly unrelated to government action or the domestic market.

B. Concluding Statement

36. In the concluding statement, the United States sought to refocus the Panel's attention on the central issues in the case. The United States explained that, although the division of responsibilities between the federal and provincial governments maybe be somewhat unclear, it should not affect the outcome of the case. This is because it is undisputed that both levels are involved in enforcing the segregation of the export market from the domestic market. The United State also emphasized again that the original Panel had found the domestic quota system to be "government action" that is indispensable to the transfer of resources from the producer to the processor.

37. Finally, the United States responded to the new legal arguments raised by Canada in its opening statement. To summarize, Canada's new legal arguments should be rejected because the original Panel did not consider the SCM Agreement in analyzing Article 9.1(c) of the Agriculture Agreement, only Article 10.1. Furthermore, the Panel considered that it was more appropriate to consider the Illustrative List of export subsidies than the general concepts of Article 1 of the SCM Agreement. Finally, Canada's interpretation of Article 9.1(c) is not supported by the language of the agreement itself or the negotiating history cited by Canada.

IV. ANSWERS TO QUESTIONS

38. The questions posed to the United States focused on the audit and enforcement mechanisms for ensuring that milk contracted for export is not redirected into the Canadian domestic system. Specifically, in response to question 19, the United States identified the several measures in each province which either prohibit, penalize or impede the diversion of milk marketed as export milk into the domestic market. The United States also pointed out, however, that the precise division of responsibilities between federal and provincial regulators should not change the outcome of this case as it is undisputed that both levels of regulators are involved in the enforced segregation of the markets.